

CBO TESTIMONY

Statement of
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before the
Committee on the Budget
U. S. House of Representatives

February 3, 1993



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Mr. Chairman and Members of the Budget Committee, I appreciate the invitation to review the economic and budget outlook with you at the start of a new Congress and a new Administration. Last week, the Congressional Budget Office (CBO) released the first volume of its annual report. The report assesses the state of the economy and updates CBO's budget projections. It also examines the economic consequences of reducing the budget deficit and the role of the budget process in enforcing a deficit reduction plan. My statement summarizes the conclusions of our report.

At long last, the U.S. economy seems to be entering a period of self-sustaining growth. But this expansion will differ from previous ones in two key respects. First, in 1993 and 1994, the economy will grow at only three-fourths of the pace that is typical for this stage of the business cycle. Second, the rate of growth will be insufficient to bring down the federal budget deficit, which will hover near \$300 billion for several years and will then grow even larger. Under current budgetary policies, the deficit will climb from \$310 billion in 1993 to \$357 billion in 1998 and about \$650 billion in 2003.

Such lackluster expansion and large budget deficits are not merely coincidental. Living standards are projected to grow so slowly, in part, because of the decline in the national saving rate over the past decade. And the federal budget deficit has been a major contributor to that drop in saving.

By the same token, reducing the deficit is the most direct and reliable way to increase national saving and long-run economic growth. Increasing the share of government spending devoted to investment could also spur growth, but the specific projects would have to be chosen carefully so that their benefits exceeded their costs. At first, efforts to eliminate the deficit would tend to weaken income and employment, but a more stimulative monetary policy could largely offset this disruption. Over the long run, a higher rate of saving would encourage new investment, boost workers' productivity, reduce net borrowing from abroad, and raise real incomes and living standards.

THE ECONOMIC OUTLOOK

Although the economy reached the bottom of the recession in the first quarter of 1991, the first year of the recovery was extremely weak, and the unemployment rate continued to rise through mid-1992. In the summer of 1992, however, the economy appears to have turned a corner. Though still slow by historical standards, the rate of growth is likely to be enough to ensure that the unemployment rate will gradually decline without requiring further fiscal or monetary stimulus.

The Forecast for 1993 and 1994

CBO forecasts that real gross domestic product (GDP) will grow at an annual rate of 3 percent in 1993 and 1994. Although this increase is well below average for the start of an expansion, it will bring the unemployment rate down from 7.3 percent at the end of 1992 to below 6 1/2 percent by the end of 1994.

CBO's economic forecast was prepared before the Commerce Department announced a 3.8 percent growth rate for the fourth quarter of 1992. When combined with the 3.4 percent figure for the third quarter, this rate makes CBO's forecast of 3 percent growth for this year seem pessimistic. It appears unlikely, however, that real consumption can continue to increase at the 4 percent pace of the last half of 1992, given the slow improvement in employment and real wage and salary income to date. Increases in consumption will probably ease as households rebuild their savings.

CBO does anticipate, however, that the recent rise in final sales will boost employment. Household employment increased by about 1.6 million between December 1991 and last December--an average of about 130,000 jobs per month--and the pace has picked up in recent months. Net job growth was slow relative to growth in output because of the usual early-expansion increase in productivity. Employment during 1993 will be helped both by the recent surge in final sales

and by slower gains in productivity. Firms will find it progressively more difficult to meet demand by using their existing employees more intensively.

The growth forecast is mild by historical standards, and one benefit of such a tepid expansion is that inflation will remain low. Given the substantial excess capacity in the economy, the consumer price index should increase by only about 2 3/4 percent a year for the next few years. Interest rates are expected to remain nearly constant through 1993, though short-term rates will rise during 1994, once the expansion is firmly established.

CBO's forecasts of economic growth and unemployment are close to those of the *Blue Chip* consensus of private forecasters (see Table 1). CBO is slightly more optimistic, however, about the prospects that low inflation and low short-term interest rates will continue. But even if CBO has underestimated inflation, the deficit projections would be little affected; although higher inflation would add slightly more to outlays than to revenues, the deficit would be no higher as a share of GDP.

Table 1.
Comparison of Forecasts for 1993 and 1994

	Actual 1991	Estimated 1992	Forecast	
			1993	1994
Fourth Quarter to Fourth Quarter (Percentage change)				
Nominal GDP				
CBO	3.5	5.1	5.4	5.4
<i>Blue Chip</i>	3.5	5.3	6.0	6.4
Real GDP ^a				
CBO	0.1	2.7	2.8	3.0
<i>Blue Chip</i>	0.1	2.7	3.0	3.2
Implicit GDP Deflator				
CBO	3.4	2.4	2.5	2.4
<i>Blue Chip</i>	3.4	2.6	2.9	3.1
Consumer Price Index ^b				
CBO	3.0	3.1	2.8	2.7
<i>Blue Chip</i>	3.0	3.0	3.2	3.6
Calendar-Year Averages (Percent)				
Civilian Unemployment Rate				
CBO	6.8	7.4	7.1	6.6
<i>Blue Chip</i>	6.8	7.4	7.0	6.5
Three-Month Treasury Bill Rate				
CBO	5.4	3.5	3.1	3.7
<i>Blue Chip</i>	5.4	3.5	3.5	4.2
Ten-Year Treasury Note Rate				
CBO	7.9	7.0	6.7	6.6
<i>Blue Chip</i> ^c	7.9	7.0	6.9	7.2

SOURCES: Congressional Budget Office; Eggert Economic Enterprises, Inc., *Blue Chip Economic Indicators*; Department of Commerce, Bureau of Economic Analysis.

NOTE: The *Blue Chip* forecasts through 1994 are based on a survey of 50 private forecasters, published on January 10, 1993.

a. In constant 1987 dollars.

b. The consumer price index for all urban consumers (CPI-U).

c. *Blue Chip* does not project a 10-year note rate. The values shown here for the 10-year note rate are based on the *Blue Chip* projections of the Aaa bond rate, adjusted by CBO to reflect the estimated spread between Aaa bonds and 10-year Treasury notes.

The Role of Monetary Policy

The economic outlook is influenced by many factors, including monetary policy and other events in financial markets. Looking back over the past few years, including both the recession and the early recovery, it is clear that the Federal Reserve followed a cautious policy that has brought down the federal funds rate roughly in line with where market forces put other short-term interest rates. This response is a contrast with other periods of recession and early expansion, when the Federal Reserve has often attempted to lead interest rates down rather than following the market. Some commentators are concerned that if this policy continues, it might keep the expansion slow.

CBO's forecast, prepared in December, did not assume any additional easing moves by the Federal Reserve, and given what we then knew, a continuation of the Federal Reserve's cautious policy, together with low inflation, seemed likely to allow real growth in the 3 percent range as we forecast. More recently, we have had some encouraging news on the state of the economy--especially reports of strong growth in the fourth quarter and good home sales in December. But the most widely watched measure of the money supply, M2, has shown little growth since last November. It is not clear whether this weakness in M2 reflects a weakness in the economy, which would require monetary action to offset, or some other factor that should not lead to additional monetary easing.

As more indicators of the state of the economy in January become known, the Federal Reserve might take action to ensure adequate growth in M2.

Projections for 1995 Through 1998

CBO does not attempt to forecast cyclical fluctuations in the economy more than two years into the future. Thus, beyond 1994, the projections are based on trends in the labor force, productivity, and national saving.

Over the 1995-1998 period, CBO projects that real GDP will grow at an average annual rate of about 2 1/2 percent (see Table 2). By comparison, potential output grows only 2 percent a year. The gap between actual and potential real GDP will therefore gradually shrink to its historical average of about 0.6 percent of potential GDP by 1998.

Because GDP remains below its potential throughout the period of the projections, inflation is not likely to rise. Long-term interest rates are also assumed to remain steady at about 6.5 percent, although short-term rates are projected to rise from 3.7 percent in 1994 to 4.9 percent by 1998.

Table 2.
Medium-Term Economic Projections (By calendar year)

	Estimated 1992	Forecast		Projected			
		1993	1994	1995	1996	1997	1998
Nominal GDP (Billions of dollars)	5,943	6,255	6,594	6,942	7,288	7,627	7,953
Real GDP (Billions of 1987 dollars)	4,918	5,054	5,204	5,354	5,497	5,628	5,740
Real GDP (Percentage change)	2.0	2.8	3.0	2.9	2.7	2.4	2.0
Implicit GDP Deflator (Percentage change)	2.6	2.4	2.4	2.3	2.3	2.2	2.2
CPI-U (Percentage change)	3.1	3.0	2.7	2.7	2.7	2.7	2.7
Unemployment Rate (Percent)	7.4	7.1	6.6	6.2	6.0	5.8	5.7
Three-Month Treasury Bill Rate (Percent)	3.5	3.1	3.7	4.4	4.7	4.8	4.9
Ten-Year Treasury Note Rate (Percent)	7.0	6.7	6.6	6.6	6.5	6.5	6.4

SOURCE: Congressional Budget Office.

NOTE: CPI-U is the consumer price index for all urban consumers.

THE BUDGET OUTLOOK

The onset of economic expansion will bring no relief from recordbreaking budget deficits. As CBO projected last summer, the federal budget deficit is stuck near \$300 billion for the next few years and will move even higher in the second half of the 1990s. If the current fiscal course is not changed, 10 years from now the deficit could reach twice today's level. Federal debt would then represent almost 80 percent of GDP, higher than at any time since the aftermath of World War II.

The Outlook for the Deficit

The federal budget deficit set a record of \$290 billion in 1992. CBO estimates that the 1993 deficit will be even higher--\$310 billion, or 5 percent of GDP (see Table 3). An expanding economy is likely to keep the deficit in check for a few years, but by 1996 or 1997 upward pressures on the deficit will again come to the fore.

These baseline budget projections assume that current laws and policies affecting tax revenues and mandatory spending remain unchanged. Discretionary spending (that is, spending controlled by annual appropriations) in 1994 and 1995 is assumed to be held to the tight limits established in the Budget Enforcement

Table 3.
CBO Deficit Projections (By fiscal year)

	1991	1992	1993	1994	1995	1996	1997	1998
In Billions of Dollars								
Total Deficit	270	290	310	291	284	287	319	357
Standardized-Employment Deficit ^a	180	201	228	222	230	256	309	351
Deficit Excluding Social Security and Postal Service	322	340	361	347	351	364	402	445
As a Percentage of GDP								
Total Deficit	4.8	4.9	5.0	4.5	4.1	4.0	4.2	4.5
Standardized-Employment Deficit ^{a, b}	3.1	3.3	3.6	3.3	3.3	3.5	4.1	4.4
Deficit Excluding Social Security and Postal Service	5.7	5.8	5.9	5.3	5.1	5.1	5.3	5.7
Memorandum: Gross Domestic Product (Billions of dollars)	5,633	5,869	6,173	6,508	6,855	7,202	7,543	7,873

SOURCE: Congressional Budget Office.

a. Excludes cyclical deficit as well as deposit insurance and Desert Storm contributions.

b. Shown as a percentage of potential GDP.

Act of 1990 (BEA). These caps require that discretionary outlays be cut by roughly 7 percent in real terms between 1993 and 1995. CBO assumes that discretionary outlays will grow at the same pace as inflation after 1995.

One can see the rising trend in the deficit most clearly in the standardized-employment deficit, which removes the effects of the business cycle from government revenues and spending. CBO projects that the standardized-employment deficit will rise, with only one slight interruption, from \$180 billion (3.1 percent of potential GDP) in 1991 to \$351 billion (4.4 percent of GDP) in 1998.

Why this grim budget outlook? After all, revenues are projected to keep pace with GDP, and most major spending programs are projected to grow no faster than the economy. However, the costs of the two major health care entitlements--Medicare and Medicaid--are expected to continue to explode. Together, Medicare and Medicaid benefits represented 3.4 percent of GDP in 1992, but they are projected to swell to 5.1 percent of GDP by 1998. The runaway growth in these programs parallels the projected growth of 10 percent a year in national health expenditures and stems largely from continued increases in the cost and use of medical care. Health care reform is currently high on the public policy agenda. But reform will almost certainly entail using public resources to extend health insurance coverage to the 35 million Americans who

are now uninsured, as well as controlling health care costs. It will prove difficult, therefore, to reduce federal health costs significantly.

More rapid economic growth is also not going to slay the deficit dragon. Even if the economy were to expand 1 percent a year more rapidly than CBO assumes--an unlikely outcome--the deficit would still total \$230 billion in 1998.

Changes in the Projections

The outlook for the 1993 deficit has brightened a bit since CBO's previous budget projections last summer, but the longer-term fiscal picture has dimmed. The revisions to the projections have nothing to do with recent legislation, which on balance has had a negligible effect on the deficit. Nor do the revisions stem from CBO's updated economic assumptions, which worsen the deficit through 1995 but improve it thereafter. The culprit is changes in other, so-called technical factors that determine revenues and spending (see Table 4).

In 1993, the largest technical reestimate is a reduction of \$45 billion in projected spending for deposit insurance. That shortfall is largely the result of a

Table 4.
Changes in CBO Deficit Projections (By fiscal year, in billions of dollars)

	1993	1994	1995	1996	1997
Summer Baseline Deficit	331	268	244	254	290
Changes					
Policy changes	1	1	a	a	a
Economic assumptions					
Revenues ^b	15	23	27	28	36
Net interest	-5	-12	-15	-17	-20
Other outlays	<u>a</u>	<u>-1</u>	<u>-7</u>	<u>-17</u>	<u>-29</u>
Subtotal	9	10	6	-6	-13
Technical reestimates					
Revenues ^b	6	4	5	6	5
Deposit insurance ^c	-45	-5	8	8	4
Medicaid	2	5	8	10	12
Medicare	a	5	8	11	14
Other major benefits	3	2	2	2	3
Net interest ^c	-2	-4	-1	1	3
Other outlays	<u>6</u>	<u>4</u>	<u>4</u>	<u>a</u>	<u>a</u>
Subtotal	-30	11	34	37	42
Total Changes	-21	23	40	32	29
Winter Baseline Deficit	310	291	284	287	319

SOURCE: Congressional Budget Office.

a. Less than \$500 million.

b. Revenue losses are shown with a positive sign because they increase the deficit.

c. Excludes changes in interest paid by deposit insurance agencies to the Treasury. These interest payments are intrabudgetary and do not affect the deficit.

delay in providing necessary funds to the Resolution Trust Corporation (RTC), the agency charged with closing or merging hundreds of insolvent savings and loan institutions. But it also reflects a modest reduction in CBO's estimate of the long-run cost of resolving troubled thrift institutions and banks, as well as a decrease in RTC's estimated need for working capital. Therefore, only part of the lower spending in 1993 is projected to be made up in the next few years.

In 1994 and beyond, higher Medicare and Medicaid spending dominates the technical reestimates. Although CBO has upped its projections for these two programs several times in the past few years, actual spending continues to outpace the estimates. In Medicare, the most rapid increases have been for care at home and in skilled nursing facilities. The growth in Medicaid is fueled by unexpected increases in the number of aged and disabled beneficiaries.

Comparison with the Bush Administration's Projections

The Bush Administration published its own baseline budget projections on January 6. Compared with the CBO baseline, the Bush Administration's projections are marked by similar deficits in 1993 through 1995 but lower deficits in the 1996-1998 period. On balance, most of the difference in the later years can be ascribed

to different assumptions about the path of discretionary spending (see Table 5). Economic and technical estimating differences are largely offsetting.

Both the CBO and Bush baselines assume that policymakers will abide by the BEA's discretionary spending caps through 1995, but they make sharply different assumptions thereafter. The CBO baseline assumes that total discretionary spending will grow at the rate of inflation after the caps expire. The Bush Administration's projections, however, assume that discretionary spending will remain frozen at 1995's dollar level. This single difference in baseline concepts trims the Bush Administration's projected deficits by \$16 billion in 1996, \$32 billion in 1997, and \$50 billion in 1998.

THE CHALLENGE OF REDUCING THE DEFICIT

Large and growing budget deficits have been a problem for a decade, and there have been many stabs at a solution. Most recently, in the 1990 budget summit agreement, the Congress and President Bush adopted a package of tax increases and spending reductions totaling almost \$500 billion over five years, as well as a set of budgetary procedures designed to assure that subsequent legislation would not erode those savings. Because the 1990 package has proved insufficient, and

Table 5.
Comparison of the Bush Administration's and CBO's Deficit Projections
(By fiscal year, in billions of dollars)

	1993	1994	1995	1996	1997	1998
CBO Baseline Deficit	310	291	284	287	319	357
Conceptual Differences						
Discretionary spending	n.a.	-1	-1	-15	-30	-45
Net interest	<u>n.a.</u>	<u>a</u>	<u>a</u>	<u>-1</u>	<u>-2</u>	<u>-4</u>
Subtotal	n.a.	-1	-1	-16	-32	-50
Economic Differences						
Revenues ^b	-5	-17	-23	-33	-48	-75
Benefit programs	a	1	6	13	21	30
Net interest	<u>2</u>	<u>8</u>	<u>12</u>	<u>12</u>	<u>14</u>	<u>14</u>
Subtotal	-3	-8	-5	-7	-13	-31
Technical Differences						
Revenues ^b	a	2	8	11	22	33
Deposit insurance	13	6	-18	-14	2	3
Net interest	3	2	1	1	4	7
Other outlays	<u>4</u>	<u>a</u>	<u>3</u>	<u>5</u>	<u>2</u>	<u>a</u>
Subtotal	21	11	-6	2	30	43
Total Differences	17	1	-11	-20	-14	-38
Bush Administration Baseline Deficit	327	292	272	266	305	320

SOURCES: Office of Management and Budget, Congressional Budget Office.

NOTE: n.a. = not applicable.

a. Less than \$500 million.

b. Larger revenues are shown with a negative sign because they reduce the deficit.

now that the economy has resumed growing, reducing the deficit is rightly receiving renewed attention.

The problem today, however, is bigger than it was in 1990. Another five-year, \$500 billion effort would not quite halve the deficit by 1998. Eliminating the deficit over the next five years would require tax hikes and spending cuts about twice as large as those adopted in 1990.

The Economic Consequences of Reducing the Deficit

CBO has analyzed the probable effects of reducing the deficit using several macroeconomic models. Even though the models differ considerably in design, they reach broadly similar conclusions.

First, closing the deficit or increasing the share of government spending that goes to productive investment would increase the standard of living that will be sustainable in the 21st century. A reasonable estimate is that eliminating the deficit would eventually increase consumption per person by more than 5 percent.

Second, efforts to reduce the deficit would tend to dampen economic activity and increase unemployment in the next few years, but a more

expansionary monetary policy could largely offset these fiscal effects. Even if the monetary stimulus were not fully offsetting, a planned steady reduction in the deficit should not throw the economy back into recession, as long as the economy is growing at the moderate rate that is projected.

Third, whether the deficit is closed in five years or 10 years makes little difference to the economy in either the short or long run, provided that the effort is credible and is carried through. Because much of the expected rise in the deficit occurs after 1998, a program to balance the budget in 10 years would come close to its goal after five years as well. In either case, the more credible the effort, the more likely that the Federal Reserve will provide the necessary monetary boost, and the more likely that private investment will rapidly fill the gap left by lower public and private consumption.

The Budget Process and Deficit Reduction

How might changes in the budget process make deficit reduction more credible? Before 1985, the laws governing the President's budgetary submission and the rules concerning Congressional consideration of the budget prescribed formats and procedures, not outcomes. In recent years, however, there have been three efforts

to construct a budget process that would achieve a specific result--namely, a lower deficit.

The first two attempts--the Gramm-Rudman-Hollings legislation of 1985 and 1987--established fixed numerical targets for the deficit and aimed to balance the budget in five years. But each time, a deteriorating economic outlook and changes in other factors led the deficit to grow more rapidly than expected and made the political burden of meeting the targets impossible to bear. The new budgetary procedure therefore proved incapable of forcing the President and the Congress to agree on the substantial tax increases or spending cuts that were needed to meet the deficit targets. Instead, policymakers turned to budgetary gimmickry and unrealistic assumptions to avoid the strictures of the law.

The Budget Enforcement Act of 1990 scrapped much of Gramm-Rudman-Hollings. It replaced the previous focus on fixed deficit targets with a concentration on enforcing the \$500 billion of deficit reduction that had been adopted at the budget summit. The BEA set up two major enforcement mechanisms--annual limits on discretionary appropriations and a pay-as-you-go requirement for revenues and mandatory spending. These procedures have succeeded in preventing new legislation from making the deficit worse, even though economic and technical factors have again caused a substantial increase in the projected deficits.

The experience of the past seven years suggests that the chances of reducing the deficit will be enhanced if attention is focused on policy first, process second. Once the Congress and the President have agreed on specific spending cuts and tax increases, then they should put in place a process to ensure that those measures are carried out. At a minimum, this process should include giving the discretionary spending limits and pay-as-you-go procedures in the BEA a new lease on life.

Reducing the Deficit Versus Increasing Government Investment

Although my testimony has focused on the effects of eliminating the federal government's deficit, the economy could gain a similar long-term improvement if the government's spending on consumption could be reduced and its spending on well-chosen investments increased. Both strategies would shift resources from consumption to saving and investment and thus increase the level of living standards attainable in the long run.

A strategy of shifting government spending from consumption to investment has the advantage that it need not, if the shift is carefully managed, weaken the economy in the short run. Some industries would be hurt and others helped, as is always the case when the government's policies change, but these

effects could be arranged to cancel themselves out roughly in the economy as a whole.

Across-the-board increases in public investment, however, are unlikely to boost greatly the productive capacity of the economy. Only if government investment choices are based on economic criteria--that is, they meet the ordinary standards of cost-benefit analysis--can they be expected to be as productive as private investments. Finding and evaluating such valuable investments take time, so the scope for sharp increases in national saving investment by that route is likely to be limited.

CONCLUSION

As was widely expected in 1990, when the Budget Enforcement Act was adopted, deficit reduction is likely to return to the top of the political agenda in 1993. At least three factors increase the chances of action this year. First, the public debt will reach its statutory limit in March, and the need to increase the limit may again force a revision of the budget process, as it did in 1985, 1987, and 1990. Second, the President and the Congress may desire some flexibility in meeting the discretionary spending limits, which are pinching more tightly. Third, the pay-as-you-go rule could use strengthening; because this requirement is scheduled

to expire in only two years, it is becoming relatively easy to shift costly programs beyond the reach of the BEA's enforcement arm.

Although these factors can set the stage for deficit reduction, they cannot make it happen, nor will they ease the political choices. The deficit will come down only when both elected officials and the public conclude that the borrowing binge must stop. They must be willing to pay higher taxes and receive fewer government benefits in the 1990s for the sake of higher living standards in the next century.